[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(S. 562 and S. 1161)

RELATING TO

EXTENSION OF TIME TO DISPOSE OF EXCESS BUSINESS HOLDINGS AND DEFINITION OF MOTOR VEHICLE OPERATING LEASE

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON JUNE 7, 1983

PREPARED BY THE STAFF

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INTRODUCTION

The Senate Finance Subcommittee on Taxation and Debt Management has scheduled a public hearing on June 7, 1983, on two bills: (1) the extension of time for private foundations to dispose of post-1969 acquisitions by gift or bequest of excess business holdings (S. 562—introduced by Senators Percy and Dixon) and (2) the treatment of certain motor vehicle operating agreements as leases (S. 1161—introduced by Senators Durenberger, Bentsen, Symms, Pryor, Wallop, Moynihan, Boren, Mitchell, Matsunaga, and Armstrong).

The first part of this pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, explanation of provisions, and effective dates.

I. SUMMARY

1. S. 562—Senators Percy and Dixon

Extension of Time for Private Foundations to Dispose of Post-1969 Acquisitions by Gift or Bequest of Excess Business Holdings

The Tax Reform Act of 1969 imposed a series of regulatory excise taxes on private foundations. One of the regulatory excise taxes applies if a private foundation acquires more than a permitted level of holdings in a particular business enterprise (known as excess business holdings). However, if a private foundation receives excess business holdings by gift or bequest, rather than by purchase, the 1969 Act provided that the private foundation has 5 years to dispose of the excess business holdings before the regulatory excise tax will apply.

The bill would grant the Internal Revenue Service the authority to grant extensions of time to dispose of excess business holdings acquired by gift or bequest after 1969. Extensions must be a minimum of 24 months.

2. S. 1161—Senators Durenberger, Bentsen, Symms, Pryor, Wallop, Moynihan, Boren, Mitchell, Matsunaga, and Armstrong

Treatment of Certain Motor Vehicle Operating Agreements as Leases

Under present law, the determination of whether a transaction is a lease, in which the lessor of the property is the owner for Federal income tax purposes and entitled to ACRS deductions and investment credits, or a financing arrangement or conditional sale, in which the user is considered the owner, generally requires a case-by-case analysis of all facts and circumstances. Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the presence of a terminal rental adjustment clause in a motor vehicle lease was taken into account in determining whether the nominal lessor would be treated as the owner for Federal income tax purposes. Section 210 of TEFRA prevents the Internal Revenue Service from retroactively denying lease treatment for motor vehicle leases by reason of the presence of a terminal rental adjustment clause. The provision is limited to operating leases in which the vehicle is used by the lessee for business purposes. Since enactment of TEFRA, the Internal Revenue Service has issued proposed regulations denying lease treatment on a prospective basis for a motor vehicle agreement that contains a terminal rental adjustment clause.

The bill would provide that the presence of a terminal rental adjustment clause in a motor vehicle operating agreement shall not be taken into account in determining whether the agreement is a

lease, regardless of whether it was entered into before or after enactment of this bill and regardless of whether the vehicle is used by the lessee for business or personal purposes.

II. DESCRIPTION OF BILLS

1. S. 562—Senators Percy and Dixon

Extension of Time for Private Foundations to Dispose of Post-1969 Acquisitions by Gift or Bequest of Excess Business Holdings

Present Law

The Tax Reform Act of 1969 imposed a series of regulatory excise taxes on private foundations. One of the regulatory excise taxes is imposed if a private foundation acquires more than a permitted level of holdings in a business enterprise (called excess business holdings).

Under those provisions (Code sec. 4943), the regulatory excise tax applies if the private foundation and all disqualified parties together hold 20 percent or more of the stock or other interest in the enterprise. If an unrelated party has effective control of the enterprise, then the regulatory excise tax is imposed only where the private foundation and all disqualified persons own 35 percent or more of the enterprise. However, there are no excess business holdings if the private foundation owns not more than 2 percent of the voting stock and not more than 2 percent of the value of all outstanding shares of all classes of stock, regardless of the ownership by disqualified persons.

If the private foundation has excess business holdings, an excise tax equal to 5 percent of the value of the excess business holdings is imposed. If the excess business holdings are not disposed of by the end of a correction period, a 200 percent excise tax is imposed.

If a private foundation acquires, after May 26, 1969, holdings in an enterprise other than by purchase (such as by gift or bequest), that acquisition does not create excess business holdings for a period of 5 years after that acquisition. In essence, this rule provides private foundations a period of 5 years to dispose of excess business holdings acquired by gift or bequest.

Explanation of the Bill

The bill would grant the Internal Revenue Service the power to grant one or more extensions of time (after expiration of the 5-year period provided by present law) to dispose of holdings in an enterprise acquired by gift or bequest after May 26, 1969, before the tax on excess business holdings would apply to such acquisitions. Any extensions which are granted would be for a period or periods which the Internal Revenue Service determines to be necessary to permit orderly dispositions of such holdings, except that any extension must be at least 24 months.

The bill would provide that the Internal Revenue Service is to take into account the following series of factors in determining whether to grant an entension:

(1) whether the private foundation has in good faith taken reasonable steps to dispose of the holdings;

(2) whether orderly disposition of the holdings can reasonably be expected to occur before the expiration of the extension period;

(3) the size of the holdings relative to other enterprises engaged in a comparable trade or business;

(4) the possible adverse economic impact caused by forced disposition of the holdings;

(5) any litigation pending against the private foundation or regulations prescribed by any governmental body which may inhibit or prevent disposition;

(6) the recommendation of the State Attorney General having jurisdiction over the private foundation; and

(7) all other facts and circumstances the Internal Revenue Service considers relevant.

The bill would provide that any initial extension may be granted immediately upon enactment of the bill. For purposes of any extention granted under the bill, the private foundation's interest in the business enterprise whose holdings constitute excess business holdings would be the stock or other interest in the business enterprise or in any of its subsidiaries immediately prior to the granting of the extension.

While the provisions of the bill would apply to any private foundation receiving excess business holdings by gift or bequest, one of the beneficiaries of the bill is expected to be the John D. and Cathrine T. MacArthur Foundation of Chicago, Illinois.

Effective Date

The bill would be effective on the date of enactment.

2. S. 1161—Senators Durenberger, Bentsen, Symms, Pryor, Wallop, Moynihan, Boren, Mitchell, Matsunaga, and Armstrong

Treatment of Certain Motor Vehicle Operating Agreements as Leases

Present Law

General rules

Cost recovery (ACRS) deductions and investment credits are allowed for property that is used for a business or other income-producing purpose. These tax benefits generally are allowed only to the person who is, in substance, the owner of the property. If the property is used in a transaction considered a lease for Federal income tax purposes, the lessor is treated as the owner entitled to ACRS deductions and investment credits. If the property is used in a transaction considered a financing arrangement or conditional sale, the user of the property is considered the owner for Federal income tax purposes. In general, the determination of whether a transaction is a lease or a conditional sale requires a case-by-case analysis of all facts and circumstances.

Although the determination of whether a transaction is a lease is inherently factual, a series of general principles is embodied in court cases, revenue rulings, and revenue procedures. Under these general principles, the lessor has to show that the property is being used for a business or other income-producing purpose. To establish a business purpose, the lessor must have a reasonable expectation that he will derive a profit from the transaction, independent of tax benefits.[1] This requirement precludes lease treatment for a transaction that is intended merely to reduce the user's costs by utilizing the lessor's tax base.

However, the fact that the lessor can show a business purpose does not automatically result in lease treatment, since a profit motive also exists in a financing arrangement. In addition, the lessor has to retain meaningful benefits and burdens of ownership.[2] Thus, lease treatment could be denied if the user of the property has the option to purchase the property at the end of the lease for a price that is nominal in relation to the value of the property at the time of exercise (as determined at the time the parties entered into the transaction) or for a price that is relatively small when compared with the total payments required to be made.[3]

Where the residual value to the lessor is nominal, the lessor may be viewed as having transferred full ownership of the property for the rental fee. Where the price under a purchase option is more

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[1] *See Hilton* v. *Commissioner*, 74 T.C. 305 (1980) *aff'd*, 671 F.2d 316 (9th Cir. 1982).
[2] *See Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976).
[3] *See* Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

than nominal but low in comparison to fair market value, the lessor may be viewed as having transferred full ownership because of the likelihood that the lessee will exercise the bargain purchase option.[4] Further, if the nominal lessor of property has a contractual right to require the nominal lessee to purchase the property (a "put"), the transaction could be denied lease treatment because a put eliminates the risk borne by owners of property in connection with fluctuations in the residual value of property and risks that there will be no market for the property at the end of the lease term.

Terminal rental adjustment clauses

Lease agreements in the motor vehicle industry often contain a terminal rental adjustment clause. A terminal rental adjustment clause permits (or requires) an upward or downward adjustment of rent to make up for any difference between the projected value of a vehicle and the actual value upon lease termination.

TEFRA

The Internal Revenue Service has taken (and continues to take) the position that the presence of a terminal rental adjustment clause in a motor vehicle lease would cause the transaction to be treated as a conditional sale for tax purposes. However, section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) prevents the Internal Revenue Service from retroactively denying lease treatment for certain motor vehicle leases, including leases of trailers, by reason of the fact that those leases contain terminal rental adjustment clauses.

Section 210 of TEFRA does not address the legal effect of terminal rental adjustment clauses, nor does it prevent the issuance of regulations addressing the legal effect of these clauses on a prospective basis. The TEFRA provision applies only to operating leases in which the lessee uses the property for business, as opposed to personal, purposes. For this purpose, a lease is an operating lease if the lessor acquires the property with cash or recourse indebtedness. Thus, the provision does not apply to leveraged leases financed with nonrecourse debt.

On November 23, 1982, after the enactment of TEFRA, the Internal Revenue Service issued proposed regulations on a prospective basis that address the legal effect of a terminal rental adjustment clause. Under the proposed regulations, the presence of a terminal rental adjustment clause would indicate that a motor vehicle agreement is not a lease.

Swift Dodge

Prior to the enactment of TEFRA, the Tax Court addressed the legal effect of terminal rental adjustment clauses in motor vehicle leases in the case of *Swift Dodge* v. *Commissioner*.[5] In *Swift Dodge*, an automobile dealership, which operated a separate leasing business, acquired most of its cars for lease by borrowing amounts from banks on a recourse basis. The Tax Court held that these nonlever-

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[4] *See M&W Gear Co.* v. *Commissioner*, 446 F.2d 841 (7th Cir. 1971).
[5] 76 T.C. 547 (1981).

aged transactions were leases and not conditional sales. However, after the enactment of TEFRA, the Ninth Circuit Court of Appeals reversed the Tax Court, holding that a lease containing a terminal rental adjustment clause was, in substance, a conditional sale to the lessee.[6] The Court of Appeals concluded that, because the lessee bore the risk of loss and, by virtue of the terminal rental adjustment clause, bore the risk of fluctuation in value, the only significant risk borne by the lessor was the risk of default by the lessee, a risk assumed by any holder of a security interest in a conditional sale.

Explanation of the Bill

The bill would provide that the presence of a terminal rental adjustment clause in a motor vehicle operating agreement shall not be taken into account in determining whether an agreement is a lease.

The bill would apply to operating leases of motor vehiles (including trailers) in which the lessee uses the property for business or personal purposes. However, the bill would not apply to leveraged leases financed with nonrecourse debt.

Effective Date

The provisions of the bill would apply to agreements entered into before or after the enactment of the bill.

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[6] 696 F.2d 651 (9th Cir. 1982), rev'g, 76 T.C. 547 (1981).